THE EFFECT OF A SALE UNDER A CONSENT DECREE AS A STEP IN CORPORATE REORGANIZATION. — Some hesitation has been felt by the courts in allowing stockholders to join in the reorganization of an insolvent corporation and the purchase of its assets at a foreclosure sale.[1] When the assets are sold, the unsecured creditors lose the chance of realizing upon any future increase in value which might be enough to satisfy their claims. This is equally true when the assets at the time of the sale are worth less than the secured indebtedness. The secured creditors have a right to force a foreclosure by sale to third parties free from claims of unsecured creditors, and when made under a decree of court no objection can ordinarily be made collaterally except for fraud in the decree.[2] But the stockholders, on account of their control over the assets, are looked upon as standing in a kind of fiduciary relation to the creditors, and it seemed a breach of this duty to allow them to purchase and to cut off the creditors' interest in a possible future value by their own private speculation. The situation is somewhat analogous to where one in a fiduciary capacity sells to himself as an individual. It has been even asserted that the assets of an insolvent corporation are held in trust for the creditors.[3] Where there is an express fiduciary relation, as in the case of a trust or executorship, it is clear that the trustee may not buy in the trust *res* even under a decree of court.[4]

There are, however, material differences in the case of stockholders buying the assets. There probably is no actual trust, and clearly the stockholders are not trustees. Furthermore, in the case of foreclosures of corporate assets the amount of capital required to purchase is so large and the market so limited that it is difficult to realize fair value for the assets.[5] This is most often accomplished by a reorganization. Upon grounds of policy to increase the market, stockholders have been allowed to join in such reorganizations, and to purchase at foreclosure sale when the sale is confirmed by judicial decree.[6] It is clear, however, that good consideration must be paid for the assets to the old insolvent corporation by all who join in the purchase. A transfer to a new corporation which merely gives new stock to the old stockholders in exchange for the old stock would be fraudulent. No consideration is given which is subject to creditors of the corporation.[7] This would be true even though the assets were worth less than the secured indebtedness,[8] for the creditors thereby lose the possibility of sharing in an increase of value and nothing has been given to the debtor corporation in exchange. Thus, while stockholders may join in a *bonâ fide* purchase they should not be given a special benefit from the reorganization in order to induce them not to

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[1] See Northern Pacific Ry. *v.* Boyd, 228 U. S. 482, 503.

[2] Robinson *v.* Iron Ry. Co., 135 U. S. 522; Kent *v.* Lake Superior Ship Canal, Ry. & Iron Co., 144 U. S. 75.

[3] See 20 HARV. L. REV. 401, where this doctrine is criticized.

[4] Michoud *v.* Girod, 4 How. (U. S.) 503; Obert *v.* Hammel, 18 N. J. L. 73.

[5] See 3 COOK, CORPORATIONS, 6 ed., § 886.

[6] Wood *v.* Dubuque R. Co., 28 Fed. 910; Thornton *v.* Wabash Ry. Co., 81 N. Y. 462. See 5 THOMPSON, CORPORATIONS, 2 ed., § 6007.

[7] When an insolvent debtor conveys property, the consideration paid must be such that the creditors may reach it or the conveyance is fraudulent.

[8] An insolvent may not give away property though it be encumbered to its full value. Garrison *v.* Monaghan, 33 Pa. 232.

obstruct the foreclosure and reorganization.[9] The stockholders clearly owe a duty to act in such corporate transactions for the benefit of creditors. Any special benefit to themselves for which they do not pay full value is analogous to an interest which a debtor who conveys seeks to retain for himself.[10] That which should have constituted a part of the purchase price has been diverted from the corporation which was entitled to it, to the stockholders who owe a duty to see that the full value of the assets are applied to creditors' claims. It follows that when by the reorganization agreement new stock, instead of being given to old stockholders, is sold to them for less than its value in order to prevent objection by the stockholders, the conveyance thereby brought about is fraudulent.[11] Even where the sale under judicial decree is for less than the secured indebtedness, a possibility of future profits has been improperly given to the stockholders.[12] In such a transaction, which is constructively, if not actually, fraudulent, the fact that the sale was under a "consent decree," which was a mere step in the improper plan, should be no more conclusive of the fairness of the sale than is a decree under which a trustee buys the trust *res*. The assets in the hands of the new corporation, therefore, should be subject to the claims of an unsecured creditor. Such seems to have been the decision of the United States Supreme Court last May.[13] *Northern Pacific Railway Co.* v. *Boyd*.[14] A more recent case purports to apply the reasoning of the *Boyd* case in holding a consent decree inconclusive of the value in another corporate reorganization. *Mechanics & Metals Nat. Bank* v. *Howell*, 207 Fed. 973. Here the creditors of an insolvent corporation purchased its assets under a consent decree, and claimed to apply to their claims the value as set by the decree, and then hold the sureties for the balance. The creditor taking over the assets of the principal debtor has a duty to take them at their real value.[15] The court admits that when the value is determined by competitive bidding the decree of sale would be conclusive of this value. But where, as the court found, the value under the decree was an arbitrary one set in the plan of reorganization,[16] and the judicial decree was

[9] Chicago, R. I. & Pac. R. Co. *v.* Howard, 7 Wall. (U. S.) 392; Louisville Trust Co. *v.* Louisville, N. A. & Ch. Ry. Co., 174 U. S. 674.

[10] The conveyance of property by an insolvent debtor reserving an interest to the debtor is clearly fraudulent. Robinson *v.* Elliott, 22 Wall. (U. S.) 513; Hurd *v.* Ascherman, 117 Ill. 501, 6 N. E. 160.

[11] Central of Georgia Ry. Co. *v.* Paul, 93 Fed. 878; St. Louis Trust Co. *v.* Des Moines, N. & W. Ry. Co., 101 Fed. 632. But see Wenger *v.* Chicago, etc. R. Co., 114 Fed. 34.

[12] But see Paton *v.* Northern Pacific Ry. Co., 85 Fed. 838, where, however, the court considered that the stockholders in the reorganization under consideration in the *Boyd* case paid fair value for the new stock. Also Wenger *v.* Chicago, etc. R. Co., *supra*.

[13] The dissenting justices were of the opinion that the stockholders properly joined in the organization and paid what the stock was worth, and also considered that the creditor was barred of relief by laches. The majority seem to have asserted that the stockholders were estopped to deny that they had received an improper benefit. For a discussion of their reasoning see footnote 16.

[14] 228 U. S. 482. See also the same case in the lower courts, 170 Fed. 779, 177 Fed. 804.

[15] Insurance Co. *v.* Randall, 42 La. Ann. 260, particularly p. 269.

[16] The court went further, and held that since the creditors formed the new corporation and issued paid-up capital stock to an amount far exceeding in par value the

given by consent in aid of such plan, it seems proper to look behind the decree, as the court did, to discover the true value as a going concern, in which condition the creditor preserved the assets. While there is no such attempt to improperly benefit stockholders at the expense of creditors as in the *Boyd* case, there is an attempt to inequitably benefit the creditor at the expense of the surety. Thus the decisions of the two cases seem analogous as to the effect of such a decree in a plan of reorganization where there are strong equitable reasons for disregarding it.[17]

PROVABILITY IN BANKRUPTCY OF CLAIMS UNDER EXECUTORY CONTRACTS. — There can be no doubt of the advantages to be gained by permitting proof against a bankrupt's estate for damages on executory bilateral contracts.[1] Where the contract has been broken by the bankrupt party before bankruptcy, it is of course clear that proof will be allowed.[2] But where there has been no breach before the bankruptcy proceedings, a question of great difficulty is presented. The authorities upon this point are meagre and in conflict. Recently the Circuit Court of Appeals for the Seventh Circuit allowed proof on the ground that the bankruptcy proceedings constituted an anticipatory breach of the

amount of the creditors' claims and received an amount of such stock equal in par value to one hundred per cent of their claims by the terms of the agreement, that they were estopped to deny that the paid-up stock was worth its face value and represented the actual value of the assets. The court went on the authority of the *Boyd* case. In that case the paid-up stock of the new corporation was issued of a par value far in excess of the amounts paid as assessments, and the old stockholders participating in the reorganization were given such stock in exchange for the old stock plus the assessments. In further supporting its view that the stockholders had retained a valuable interest, the court said that since it was agreed in the reorganization that the property was equal in value to the paid-up stock, the stockholders could not be heard now to assert as against the plaintiff, an unsecured creditor, that this was not true. It is hard to support this on any principles of estoppel. It is submitted that it is at most a *dictum*, and was not meant to be carried to the extreme seen in the later case.

The policy of the law is opposed to the issue of paid-up stock for less than its value. See 4 THOMPSON, CORPORATIONS, 2 ed., §§ 3904, 3911. Those subscribing who have not paid the full value may be compelled to pay the full value by creditors who have acted in reliance. *Bonâ fide* stockholders who have paid full value can complain. Barsus *v.* Gates, 89 Fed. 783. The policy of the law is also to protect the public from the danger of paid-up stock which does not represent actual capital. In the *Boyd* case the plaintiff was not in any way deceived, nor did he act in reliance upon the stock being paid-up stock. If it be assumed that the stockholders paid the actual value for the new stock, it is hard to see why public policy should dictate that they should be penalized by granting a pure benefit to the plaintiff in the form of a claim against the new corporation. Similarly, in the *Howell* case, the surety was not deceived, and invoking any theory by which the surety is given a pure benefit at the expense of the organizers would seem to be improper.

17 Apparently the doctrine of the *Boyd* case is taken to be that no objection by interested parties is necessary at the time of the decree. Whether the Supreme Court means to go to this length is doubtful in view of the fact that in the *Boyd* case the majority considered that the plaintiff was in no position to object at the time of the decree.

1 To refuse proof is to deprive bankrupts of the full benefits of discharge, by forcing them to bear the burden of many claims which cannot be released and which will become due soon after the bankruptcy.

2 *In re* Silverman, 101 Fed. 219; *In re* Stern, 116 Fed. 604; *In re* Saxton Furnace Co., 142 Fed. 293; *In re* Spittler, 151 Fed. 942.